ECB Watch

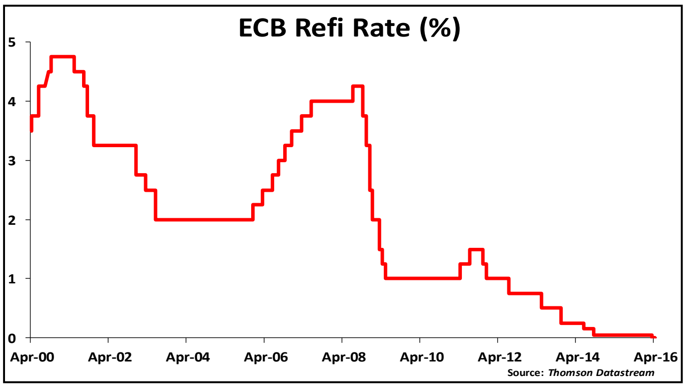
21st April 2016

AIB Treasury Economic Research Unit

ECB willing to use all available instruments

Today's meeting of the ECB's Governing Council for April concluded with no changes to monetary policy. The lack of any policy changes was expected as the ECB had only announced a raft of additional easing measures last month.

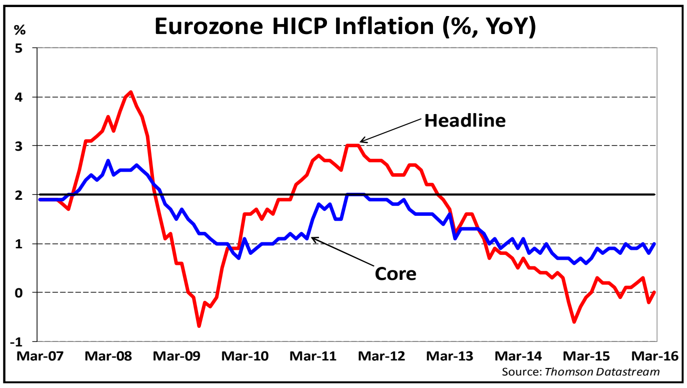
ECB President Mario Draghi stated in his press conference that the **ECB is now focused on the "implementation of the measures announced in March.** This included cutting the deposit rate by a further 10bps, to -0.4% and reducing the refi rate by 5bps to 0%. In addition, the ECB increased the volume of its asset purchases to €80bn per month, from €60bn, as well as expanding the basket of QE eligible assets. It also announced the launch of four new four-year TLTROs over the course of next twelve months, starting in June 2016.



The contents of the April statement and tone of the press conference showed that the Governing Council remains very much cognisant of the heightened risks to the ECB's price stability objective, and the need to counteract these risks in order to achieve a return of inflation towards levels that are below, but close to, 2%.

Indeed, the statement once again emphasised that the risks to its economic outlook "still remain tilted to the downside". The Governing Council also noted that "uncertainties persist and relate, in particular, to developments in the global economy and to geopolitical risks".

These concerns were very much evident in the most recent ECB staff macro projections, which were released at its March meeting. In these projections the **ECB slashed its inflation forecast for this year from 1% to 0.1%.** It also lowered this year's GDP growth forecast to 1.4% from 1.7% previously. The ECB envisages growth and inflation picking up in 2017 and 2018.



Not surprising then, the **ECB emphasised its willingness to act again, if necessary, by "using all the instruments available within its mandate".** President Draghi was asked to clarify his comments from the March meeting which suggested that Eurozone interest rates may be at a trough. He rowed back somewhat on those comments by stating that the ECB was prepared to use all the policy options at its disposal and that the key factor for the Governing Council in terms of negative interest rates was an "issue of extent". He discussed the **experience so far of negative interest rate policy in the Eurozone, saying that it had not caused banks' net interest income to fall, nor had there been any significant pass through to depositors and that "all in all, the experience had been positive".**

In summary then, the ECB has not ruled out cutting interest rates again, if required, however, the extent of any further cuts could be relatively modest in nature judging by Draghi's comments. In the immediate aftermath, the euro strengthened, with EUR/USD trading up from the $1.13 level to test up at $1.14 before falling back to $1.13. Bond yields rose but this may have more to do with the recent strength of oil prices.

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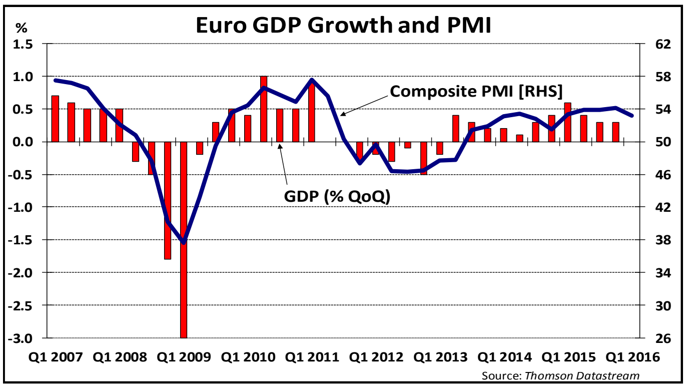
Recent data provide conflicting signals

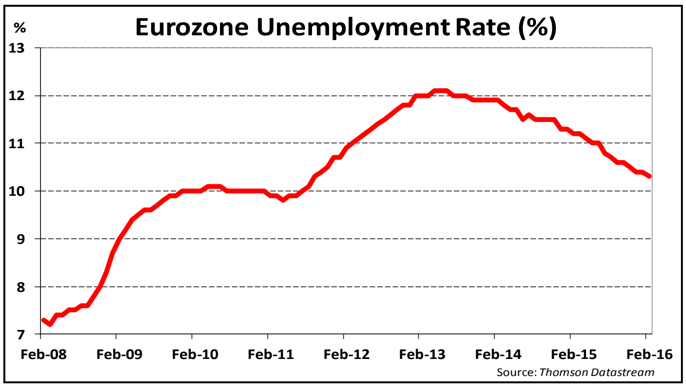
Updated Eurozone GDP data have confirmed that the economy grew by 1.6% in 2015. While growth was modest, it still represented an improvement on the 0.9% recorded in 2014. GDP was also more balanced, with all Eurozone countries, with the exception of Greece, growing. GDP benefitted from strong exports in H1, as well as a modest revival in consumer spending.



In terms of the performance of the economy so far this year, leading indicators of activity for Q1 pointed to a slowdown in the pace of growth from the 0.3% recorded in Q4 last year. The influential Markit composite PMI averaged 53.2 in the first quarter, after Q4's 54.1. Meanwhile, the EC economic sentiment index averaged 104 in Q1, compared to 106.2. Meantime, national level survey data, such as the German Ifo, French INSEE and Italian ISTAT indices, have also pointed to a slowdown in growth.

However, recent 'hard' data releases have been generally more positive than the survey data have suggested. For example, retail sales rose by 0.8% in January/February versus Q4. Growth was spurred on by further solid pick-ups in food sales. On the output side of the economy, industrial production grew by 1.1% in Jan/Feb. This is in part due to some recovery in the energy sector, which had been weighed down in Q4 by a period of unseasonably warm weather.

Despite Eurozone growth remaining modest, improvement in the labour market has picked up pace. The unemployment rate fell to 10.3% in February, a 4½-year low. While this figure does hide a worrying dichotomy—German unemployment rate at 4.3%, versus 10.2% in France and 20.4% in Spain—the gap has narrowed.



Meantime, year-on-year growth in employment continued to accelerate in 2015, reaching a 7½-year high of 1.2% in Q4. In terms of the near term outlook, the Eurozone composite employment PMI averaged 51.9 in Q1, broadly unchanged from Q4's 52.3 average. **This suggests that we may see employment continue to grow at a moderate pace in the opening half of 2016.**

Monetary aggregates were much improved last year. However, year-on-year growth in M3 money supply looks to have levelled off at around 5% in recent months, though it is still much stronger than one year previous. The pace of growth in lending to the private sector has started to increase again, after slowing in recent months. Year-on-year growth rose to 1.1% in February, though it is still below November's four year high of 1.2%.

Overall, growth in the Eurozone is expected to remain moderate as it still faces some significant challenges. These include high levels of unemployment in many countries, a lack of structural reforms in some economies, the negative impact from a slowdown in growth in emerging markets (especially China) and related global risk aversion, as well as the potential for negative geo-political developments and the uncertainty over the upcoming UK EU referendum. **However, there are also some positives for the economy,** including the favourable impact from lower commodity prices, a weaker euro and the impact of monetary policy easing, with interest rates likely to remain at very low levels for the next few years. **In its April 'World Economic Outlook', the IMF forecast GDP growth in the Eurozone of 1.5% this year, and 1.6% in 2017.** This is broadly in line with the ECB's most recent economic projections and suggests there will be little change in economy's growth performance in the next couple of years.

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